

PROPRIETARY]

[END BELL ATLANTIC

4. **The Staff's Rescoring Standard Was Consistently Applied.**

The RBOCs' claim that the Staff inconsistently applied its rescoring standard also fails to withstand scrutiny.²⁵ Professor Loebbecke has thoroughly examined the Staff's rescoring of the sampled items in the Bell Atlantic audit, and has found that the Staff's rescoring standards were consistently applied. Loebbecke Reply Aff. ¶ 22-25.

The Staff explanation for rejecting the rescoring of an item was detailed and specific. These explanations were consistent among those of like kind as well as with the audit staff's published rescoring procedures. In many cases, adequate documentation was simply missing. *Id.* at 24. In particular, documentation of the following types was missing. **[BEGIN BELL ATLANTIC PROPRIETARY]**

²⁵ See, e.g., Ameritech Comments at 15, 18-19; Bell Atlantic Comments at 7; SBC Comments at 26 & Exh. B at 2.

[END BELL ATLANTIC PROPRIETARY]

Furthermore, and contrary to the RBOCs' assertions, the Staff did not engage in allegedly inappropriate "back-at-the-office" rescoring. As MCI WorldCom explains, the Staff rearranged certain scoring categories after the audits were performed to reflect better that certain categories included missing equipment, and that another category included equipment that likely existed. Notice of Inquiry, *MCI WorldCom Comments* at 22, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("MCI WorldCom Comments"). Thus, the Staff's rescoring procedures simply reflected the Staff's commitment to make the audits fair, accurate, and consistent, and did not represent, as the RBOCs contend, a sinister attempt to inflate the number of items classified as missing.

5. The Staff's Rescoring Standard Did Not Violate The Administrative Procedure Act Or Otherwise Prejudice The RBOCs.

Some of the RBOCs contend that the Staff violated the Administrative Procedure Act ("APA") and otherwise prejudiced the RBOCs by allegedly failing to inform the RBOCs of the rescoring standard the Staff applied in reviewing the sufficiency of the RBOCs' post-audit

documentation. *See, e.g.*, Bell Atlantic Comments at 4-5; Ameritech Comments at 13, 17, Exh. B at 6; SBC Comments at 18-19 & n.53. This argument is unfounded for several reasons.

As an initial matter, the adjudicative standard applied by the Staff to assess the probative value of the RBOCs' evidence is neither a regulation nor a procedure subject to the APA, and the RBOCs' claims of retroactive rulemaking therefore are baseless. In any event, on June 27, July 8, and October 8, 1997, the Staff provided preliminary results to the RBOCs, and specifically asked them to provide *all* additional explanations and documentation they wanted the Staff to consider in potentially rescoring items initially scored as "not found." BA-North Rpt. ¶ 19 n.29. Moreover, as SBC concedes, the Staff had discussions with the RBOCs concerning the sufficiency of their evidence "early in the [rescoring] process," and thus the RBOCs were well aware from the very beginning of the rescoring process that the Staff considered much of the RBOC evidence to be insufficient. SBC Comments at 19 n.53. And, as BellSouth concedes, the Staff issued another request on March 11, 1998, asking for all "the necessary documentation that [the RBOCs] believe will support [their] position by April 7, 1998." BellSouth Comments at 21 (quoting Letter from Kenneth Ackerman, Chief, Audits Branch to Mary L. Henze, BellSouth (Mar. 11, 1998) (attached as Exh. 4 to BellSouth's comments)). In these circumstances, the RBOCs' argument rests on an assumption -- that the RBOCs held pertinent information back because they allegedly were not aware of the Staff's rescoring standard -- that is obviously false. The Staff asked for any documentation the RBOCs cared to submit, and the RBOCs had every incentive to submit whatever favorable information they could obtain. Thus, it is not surprising that, despite their claims of lack of notice, the RBOCs to date have failed to identify *any* additional information that they would have submitted had the *Rescoring Report* been issued at an earlier time.

D. The Audit Procedures Complied With GAAS And GAGAS.

The RBOCs also allege that the Staff's procedures failed to comply with GAAS, and that the Staff improperly relied on GAGAS. *See, e.g., Ameritech Comments at 13-14.* This allegation should be rejected at the outset. Even Arthur Andersen concedes that the Staff's procedures were "similar in many respects" to the procedures followed by the RBOCs' own accounting firms. *Ameritech Comments, Exh. A, at 13.* In any event, as Mr. Loebbecke explains, the Staff was not required to comply with GAAS, but reasonably looked to the GAAS and GAGAS standards for guidance, and generally complied with them. *Loebbecke Reply Aff. ¶ 27.*

The audits conducted by the Staff were an entirely appropriate approach to the exercise at hand. To the limited extent that the procedures could, with hindsight, have been improved (which could be said of virtually any audit), that in no way undermines the Staff's ultimate conclusion that a significant amount of equipment listed in the CPRs is missing. As the Florida PSC and the New York State Attorney General both note, regardless of any minor deficiencies in the Staff's procedures, the sheer size of the problems identified through the Staff's audit indicate that corrective action is warranted. *Florida Comments at 1-2, 5; New York Comments at 7-8.*

This is confirmed by consideration of the nine "errors" that the RBOCs claim the Staff auditors made. First, the RBOCs contend that the Staff violated GAAS by failing to perform "corroborating testing of account balances or other financial statement accounts." *See, e.g., Ameritech Comments at 13.* As Professor Loebbecke explains, however, the Staff audits were not intended or claimed to be general purpose audits of financial statements conducted in accordance with GAAS. The Staff audits were in fact special purpose audits of limited scope, conducted in accordance with GAGAS. Their scope was defined by the description of the

procedures performed. These included physical inspection and review of documented submitted by the RBOCs for rescoring. The conclusions of the audit Staff were based on the results of those procedures, as stated and described in the Staff reports and in Public Notice DA 99-668. Loebbecke Reply Aff. ¶ 29.

Second, the RBOCs contend that the Staff violated GAAS by failing to review “internal controls over the hardwired COE CPRs.” *See, e.g., Ameritech Comments at 13.* As Professor Loebbecke notes, the requirement to review internal controls under GAAS is contained in the second standard of fieldwork, as follows:

There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

In a conventional audit of financial statements by an outside auditor, a central purpose of which is to check the adequacy of internal controls, this standard requires the auditor to understand the company’s internal controls well enough to plan his tests, and to test those controls if the auditor intends to limit the scope of his procedures. The Staff specific purpose audit was designed to test the accuracy of the CPRs, not the adequacy of the RBOCs’ internal controls. But, even if this GAAS standard applied to the Staff’s limited scope GAGAS audit, the Staff’s work will meet it. The Staff did have sufficient knowledge to adequately plan and conduct their selected procedures. Furthermore, the scope of the Staff’s procedures was not limited; it was based on a 95 percent confidence level, an examination which is considered to be extensive under professional standards and practices. Bell Reply Aff. ¶ 29.

Third, the RBOCs contend that the Staff violated GAAS by failing “to communicate its [rescoring] standards” before the release of the *Rescoring Report*. *See, e.g., Ameritech Comments at 13.* As demonstrated above, that contention is baseless. The audit Staff repeatedly

asked the RBOCs to provide *all* additional explanations and documentation they wanted the Staff to consider in potentially rescoring items initially scored as “not found,” and the RBOCs did so. The RBOCs had every incentive to submit whatever favorable information they could obtain, and there is no evidence in the record that the RBOCs held pertinent information back.

Fourth, the RBOCs contend that the Staff violated GAAS by “[a] nearly exclusive reliance on physical inspection as the only competent evidential matter considered.” *See, e.g.,* Ameritech Comments at 13. As demonstrated above, that contention also is baseless. The Staff fully considered all of the RBOCs’ post-audit documentary submissions, its rescoring standard was eminently reasonable, and the Staff in fact performed a significant amount of rescoring based on that evidence and according to that standard.

Fifth, the RBOCs contend that the Staff violated GAAS by engaging in “limited communication with [RBOC] management as a source of audit evidence and to validate audit results.” *See, e.g.,* Ameritech Comments at 13. The RBOCs fail to explain what additional information in the possession of RBOC senior management would have assisted the audit Staff in clearing up the scoring of specific items of HWC OE. The audit Staff repeatedly invited the RBOCs to provide further information. If the RBOC personnel involved in the audits failed to bring these requests to the attention of more senior management, the responsibility for this internal failure of communication lies with the RBOCs themselves.

Sixth, the RBOCs contend that the Staff violated GAAS by failing to account for the lapse of time “between the date of the sampled report and the physical verification.” *See, e.g.,* Ameritech Comments at 13. As shown in MCI WorldCom’s initial comments, however, interim retirements were scored as “found” to the extent the RBOCs were able to provide evidence

showing that such retirements had in fact occurred. MCI WorldCom Comments at 19-20. Accordingly, this criticism is entirely misguided.

Seventh, the RBOCs contend that the Staff violated GAAS by performing "limited and restrictive field audit procedures." *See, e.g., Ameritech Comments at 13.* As described above, however, this allegation is false in numerous respects. The auditors remained at each central office location until the RBOCs' *own personnel* agreed that the missing items could not be found and that a exhaustive search for the sample items had been performed. Thus, the RBOCs were given a virtually unlimited opportunity to locate the sampled equipment, and simply failed to do so. In addition, the RBOCs' claim fails to recognize that the Staff's initial scoring during the on-site inspection was extremely generous to the RBOCs.

Eighth, the RBOCs contend that the Staff violated GAAS by failing to perform follow-up field visits. *See, e.g., Ameritech Comments at 13.* In a perfect world of unlimited time and money, follow-up visits might be appropriate. In the real world in which the RBOCs were given ample advance notice of the initial field visits and every opportunity to locate audited items, the RBOCs have offered no compelling justification for the delays and expense of follow-up field visits. Certainly, the failure to conduct follow-up visits cannot change the fact that *all* of the information before the Commission, including the reports of the RBOCs' own accounting firms that performed such follow-up inspections, shows that a significant amount of equipment is missing. Accordingly, the Staff's inability to perform follow-up visits does not provide any basis to disparage the Staff's procedures or for the Commission to fail to mandate remedial action. *See Loebbecke Reply Aff. ¶ 32.*

Finally, the RBOCs contend that the Staff violated GAAS by "[t]he restrictive review afforded companies to comment on the draft audit findings." *See, e.g., Ameritech Comments at*

13. As demonstrated above, that contention is completely false. On at least four separate occasions, the RBOCs were invited to provide the Staff with whatever documentation or other evidence they deemed relevant to show that missing items had in fact been found, and the RBOCs had every incentive on each of these occasions to submit all such evidence they had in their possession. AT&T Comments at 18.

E. Reports Of Accounting Firms Hired To Refute The Staff Report Are Devoid Of Probative Evidence.

In an after-the-fact effort to rehabilitate their CPR, the RBOCs hired several large accounting firms to review the Staff's audit. To this end, accounting firms purported to reenact their clients' audits by visiting the central offices and looking for equipment that the Staff was unable to find. Unsurprisingly, the accountants' reports assert that some—but, tellingly, not all—of the CPR scored by the audit staff as missing should have been scored as found.

The results of this reenactment are entitled to no weight for the simple reason that the audit reports are essentially black boxes. Almost none of the source documentation purportedly relied on by the accountants in reenacting the audits have been released to the public. Hence, the accountants' results can be neither tested nor replicated.²⁶

²⁶ Although Ameritech attached a small amount of documentation to its comments, the attachments are both incomplete and redacted to the point of illegibility. See e.g. Ameritech Comments Att. C to Att. B at 3 (two black squares and illegibly faded writing); *id.* at 11 (same); *id.* at 12-13 (same); *id.* Att. G to Att. B (mostly copies of illegible faxes).

Reliance on such analyses would violate the interested parties' right to test underlying data and assumptions.²⁷ The opinions of outside auditors, no matter how reputable, cannot be the last word for reporting entities whose financial reports and accounting practices are at issue in a regulatory proceeding.²⁸

In addition, the portions of Ameritech's documents that can be deciphered indicate that its rescoring standards were overly lenient. For example, Ameritech's CPR report included a 1992 vintage piece of equipment. Ameritech Comments, Att. C to Att. B., App A-4 at 10. The Staff could not find that piece of equipment during the on-site office and, therefore, categorized it as "Not Found." Arthur Andersen also failed to find the equipment, but assumed that a different (and much older) piece of equipment that performs the same task as the item listed in the CPR was the same equipment listed in the CPR description.

²⁷ See *Mail Order Ass'n of America v. United States Postal Service*, 2 F.3d 408, 430 (D.C. Cir. 1993) (overturning agency cost findings because, *inter alia*, the parties were "afforded no opportunity . . . to test, or even examine, the methodology . . . or the figures and calculations used to attribute access costs").

²⁸ See e.g. *Review of Affiliate Transaction At Ameritech Services, Inc.*, 1995 FCC LEXIS 4555 (May 9, 1995) ("it is important to recognize that this audit report is not the first time an audit has arrived at different conclusions than outside auditors. The General Accounting Office 1992 Report to Congressional Requestors points out that the Federal Communications Commission has regularly arrived at materially different findings than outside auditors."); *Amerada Hess Pipeline Corp.*, 71 FERC ¶ 61,040 (1995) at 61,166 (rejecting accounting classification approved by carrier's outside auditor, and noting that where the "measurement and classification of items directly affect the amounts [regulated companies] . . . may charge . . . the carrier has the burden of proving . . . its accounting is just and reasonable. . . . That burden of proof carries with it an obligation to produce substantial evidence for the record sufficient to show the justness and reasonableness of its proposal"), *aff'd*, *Armada Hess Pipeline Corp. v. Federal Energy Regulatory Commission*, 114 F.3d 596 (D.C. Cir. 1997).

This assumption has two obvious flaws: (1) Arthur Andersen apparently did not search the CPR to verify whether the older piece of equipment was separately listed elsewhere in the CPR; and (2) even if the older piece of equipment was not listed elsewhere in the CPR, Ameritech's failure to specify the actual vintage for the item affects cost calculations. Newer items are more valuable and may depreciate faster. Both alternative scenarios would give Ameritech an illegitimate windfall at the expense of ratepayers. *See* Loebbecke Reply Aff. 37.

Similarly, Arthur Andersen counted items as "found" even when produced by a *different manufacturer* than listed in the CPR. *See, e.g.,* Ameritech Comments, Att. C to Att. B, App. A-4 at 17. There is no evidence that Arthur Andersen confirmed that these different items were not already listed in the CPR, nor is there evidence that the items made by different manufacturers were identically valued or that they depreciated at the same rate. Arthur Andersen also accepted as "found" items that were purchased in 1989, but included a price quote from a 1996 price list. Ameritech Comments, Att. E to Att. B. Likewise, Arthur Andersen removed items from the "not found" category because they saw some items of similar description in the basement of the central office, although the corresponding entries in the CPR recorded the items as upstairs, on an entirely separate floor. Ameritech Comments, Att. I to Att. B. The Staff properly counted these items as "not found" because there was no way to verify that the items in the basement were the ones listed in the CPR.

Nevertheless, even with all of these overly generous rescoring standards, these hired accountants still confirmed that most of the items found missing by the Staff were actually missing. For example, Staff found 96 of the sample HWCOE missing from BellSouth's central offices; PricewaterhouseCoopers notes that "only" 84 of the sample HWCOE are missing. *Compare BellSouth Rpt.* at 9, *with* BellSouth, Exh. 5, at 3. Similarly, Staff scored 104 of the

sampled HWCOE missing from Ameritech's central offices; Arthur Andersen scored 90 of the sampled HWCOE missing. *Compare Ameritech Rpt.* at 9, *with* Ameritech Comments, App. A-5, Att. 2 at 1 (Attachment to the Affidavit of Paul F. Charnetzski citing Arthur Andersen Study). Thus, even the RBOCS' own auditors confirm that the RBOCs were in significant non-compliance with the CPR requirements.

III. THE STATISTICAL PLAN WAS PROPERLY CARRIED OUT USING THE ACCURATE DATA COLLECTED BY THE AUDITORS.

The parties' initial comments confirm the illegitimacy of the RBOCs' efforts to hide their missing HWCOE through statistical manipulation—in particular, claims that: (1) the estimated value of the missing equipment should be based on the lower bound of the relevant confidence interval, (2) the relevant confidence interval is 99 percent, not 95 percent, and (3) the lower bound of the 99 percent confidence interval is zero (or even below zero). *Compare* BellSouth, Exh. 3 (Ernst & Young statement); Bell Atlantic Response at 12; *accord*, SBC Comments at 8-9; BellSouth Comments at 18 *with* AT&T Comments at 24-29.

There is no doubt that equipment recorded in the CPR is missing; the question is how much. Despite the best efforts of their own engineers and outside auditors, the RBOCs were unable to find a substantial amount of the HWCOE listed in the CPR. Thus, by definition, the value of missing equipment in the sample *must* exceed zero, and so must the value of missing equipment in the universe.

The purpose of the audit process is to estimate the amount of that overstatement, and the best estimate of the amount of overstatement is, by definition, the point estimate.²⁹ By choosing

²⁹ A confidence interval is a range of numbers that is, to some degree of confidence, likely to contain the true value. The one number that is the best estimate of the true value, however, is the

(continued . . .)

the point estimate, the statistician minimizes the overall risk of a large mistake in either direction.³⁰ Therefore, when a statistician must choose an estimate from within a confidence interval, the most logical choice is a number near the center, usually the point estimate. See AT&T Comments at 26-27.³¹

Moreover, the 99 percent confidence interval proposed by RBOCs is excessive even as a test of statistical significance. As AT&T explained in its initial comments, a 99 percent confidence level increases the range of numbers included in the confidence interval so greatly that the statistician generally cannot draw any useful conclusions from the sample. The confidence level commonly used by statisticians is the 95 percent level assumed by the audit Staff, and the Commission recently adopted a confidence interval of 90 percent to evaluate compliance with its rules, on the ground that a higher confidence interval would prevent detection of rule violations. *Id.* at 28.

The absurdity of the RBOCs' position is exemplified by their claim that the lower bound of the relevant confidence interval is zero—or even negative. As noted above, this conclusion is impossible: the population of a group can never be less than zero, and existence of one or more

(... continued)

point estimate. See Thomas H. Wonnacott & Ronald J. Wonnacott, *Introductory Statistics for Business and Economics* 254 (4th ed. 1990). Point estimates are designed to provide the researcher with most accurate estimate of the true value of the population. *Id.*

³⁰ Using the lower bound would increase the risk of greatly understating the actual mean value for the entire population; using the upper bound would increase the risk of overstating the actual mean.

³¹ The basic methods of calculating confidence intervals ensure that the point estimate will be near the center of the confidence interval. See Wonnacott, *supra*, at 254.

missing items of HWCOE in the sample necessarily means that one or more items must be missing from the entire universe. Bell Aff. ¶ 33.³²

Finally, the parties' initial comments confirm that the Staff's point estimates are sound. As AT&T noted in its comments, the formulas used by the Staff to calculate the point estimates are found in leading sampling theory textbooks. AT&T Comments at 27. Even the RBOCs concede that any resulting statistical bias "appears to be negligible." Bell Atlantic Response, Exh. 2, at 5; BellSouth Comments 3, at 4. It is thus unsurprising that the RBOCs have little to say about the methods employed by the Staff to calculate the point estimates.³³

IV. THE ESTIMATED \$2.9 BILLION OVERSTATEMENT OF THE RBOCs' HWCOE CPR PLAINLY WARRANTS CORRECTIVE ACTION.

The Commission's findings are consistent. The Staff found that all of the RBOCs were missing from their central offices at least 15 percent (and as much as 30 percent) of the HWCOE listed in their respective CPRs. The aggregate point estimate of missing equipment, based on the Staff's point estimates, is \$2.88 billion.³⁴ See AT&T Comments at 30. Clearly, some corrective action is needed to remedy the RBOCs' massive overstatement of HWCOE.

³² Most of the RBOCs, like the audit Staff, have overlooked the fact that the relevant confidence intervals are unlikely to be symmetric: that is, the upper limit should be further from the point estimate than is the lower limit. While Bell Atlantic appears to have recognized the problem, its proposed cure exacerbates the problem. See Bell Reply Aff. ¶¶ 21-23.

³³ The Staff analyses closely follow the scientifically rigorous textbook method for calculating statistical error. See generally, Cochran, *supra*, Ch. 11. Indeed, even the RBOCs admit that, to the extent that the data collected are correct, "[t]he audit sampling plan was designed to produce a precise estimate of the proportion [of missing HWCOE]." Bell Atlantic Response, Exh. 2, at 3; BellSouth Comments, Exh. 3, at 4.

³⁴ Indeed, even this number appears to be too low, because recent revisions of the Staff's analysis of the HWCOE shortfall indicates that U S West's shortfall may have been underestimated by \$125 million. See, "Corrections to Audit Reports of Bell Operating Companies' continuing Property Records," CC Docket No. 99-117, ASD File No. 99-22, *Federal Communications Commission Public Notice*, released 10/22/99.

A. Ratepayer Impacts.

The comments confirm that the several billions of dollars of phantom investment central office equipment in the RBOCs' CPR have substantially inflated the RBOCs' access charges and other rates. The RBOCs comments do little more than rehash the arguments of Bell Atlantic that AT&T and others have already shown to be baseless. *See* AT&T Comments at 29-36; MCI WorldCom Comments at 34-40.

For example, many of the RBOCs continue to advance the baseless contention that errors in the CPR have no effect on the USOA accounts. *E.g.*, Bell Atlantic Comments at 8; SBC Comments at 52; U S WEST Comments at 26. As AT&T and others showed, the Commission's rules require the RBOCs to reconcile the USOA accounts and the CPRs on an annual basis. AT&T Comments at 30-31; 47 C.F.R. § 32.2000(e)(2)(iii). Indeed, the CPRs are the *only* source data for recording retirements of equipment in the USOA accounts. Bell Atlantic Response at 14. Therefore, if the RBOCs have improperly failed to remove from the CPRs equipment that has been retired or that was never placed in service at all, then there is necessarily a corresponding failure to remove that equipment from the USOA accounts, and those accounts are thus overstated.³⁵

With respect to the impact of the overstatements on the RBOCs' revenue requirements, the RBOCs simply restate arguments that have already been refuted by the Snively King Report. *See* MCI WorldCom Comments, Att. 2 ("Snively King Report"). As the Snively King Report

³⁵ *See, e.g.*, Chairman's Letter, Attachment at 4-5 ("a proper reconciliation requires an investigation of differences so that corrections can be made either to the CPRs or to the books of account as appropriate. Accordingly, whatever is misstated in one is misstated in the other, and, absent a showing to the contrary by the carriers, the auditors logically conclude that the overstatements found in the CPR are also present in the regulated books of account").

demonstrates, the overstatements in the RBOCs' USOA accounts do result in overstatements of the RBOCs' revenue requirements. The magnitude and nature of the effect on the revenue requirements depends on whether the plant was ever in service at all, or whether the LEC merely improperly failed to record the retirement of plant that was once in service (a "delayed" retirement)—and when the actual retirement occurred. If the plant was never put in service at all, the result is an overstatement of both the rate base and depreciation expense. Snavelly King Report at 4-6. If the error is a "delayed retirement," the result is still an overstatement of depreciation expense. *Id.* at 6-9.

None of the RBOCs offers any evidence that any of the equipment that they cannot now locate was ever in service. The Snavelly King Report concluded that the notion that all of the missing equipment are delayed retirements is highly implausible, and the RBOCs have done nothing to rebut that conclusion. Snavelly King Report at 3-4. As shown before, at a minimum the missing equipment from more recent vintages were almost certainly never in service, because retiring equipment so quickly after its entry into service would be highly unusual. *Id.* at 9-10. Moreover, the rate impact of missing equipment that was never in service is especially severe, since it results in an overstatement of both the rate base and depreciation expense. Snavelly King Report at 4-5.

In addition, contrary to the insistence of the RBOCs, delayed retirements cause an overstatement of depreciation expense. Snavelly King Report at 6-9; *see* Ameritech Comments at 24; BellSouth Comments at 44-45; Notice of Inquiry, *Comments of GTE* at 9, CC Docket No. 99-117, ASD File No. 99-22 (Sept. 23, 1999) ("GTE Comments"); SBC Comments at 52-53; U S WEST Comments at 27. On this point, the RBOCs do nothing more than repeat arguments that the Snavelly King Report has refuted in detail. As explained before, if the retirement had

been recorded properly, the remaining life depreciation rate would not have changed (because the decrease in the reserve ratio would have been canceled out by the increase in the remaining life). Snavely King Report at 6-9. Therefore, a delayed retirement results in the same depreciation rate being applied to an *overstated* gross plant. Delayed retirements therefore result in an overstated depreciation expense, and an overstated revenue requirement.

Similarly, the Snavely King Report refutes the RBOCs' arguments, repeated again in their comments, that the overstatement of depreciation expense would not affect the RBOCs' revenue requirement under the Commission's pooled depreciation methodology. Snavely King at 7-9; *see* Ameritech Comments at 24-25; Bell Atlantic Comments at 8; BellSouth Comments at 45; SBC Comments at 52. As Bell Atlantic's expert previously conceded, there is no *fixed* relationship between a failure to retire plant and the revenue requirement; it may increase or decrease depending on the "direction of movement in the composite remaining life of a plant category." Bell Atlantic Response, Exh. 5, ¶ 6 ("White Aff."). Specifically, if the delayed retirements are concentrated in the older vintages, the result would be an overstated gross plant and an understated remaining life, and thus an overstated revenue requirement. Snavely King Report at 8-9. The delayed retirements *are* likely to be concentrated in the older vintages, because it is unusual to retire equipment within a few years of deployment. *Id.* at 9-11.

Because overstatements in the RBOCs' USOA accounts indisputably inflate their revenue requirements, the RBOCs' argument that the phantom equipment has not resulted in excessive rates collapses. Because the price caps were initially set at the RBOCs' rates as of July 1,

1990,³⁶ any missing equipment that was missing on that date would have caused the initial price caps to be overstated. Moreover, as explained before, to the extent that the initial price caps were overstated, the price caps have been at excessive levels *every year since 1990*, and indeed, those overstatements would persist to this day. As AT&T and others showed, there is good reason to believe that much of the equipment was in fact missing as of 1990, *see* AT&T Comments at 33-34; MCI WorldCom Comments at 39-40, and the RBOCs have offered no evidence to cast doubt on that conclusion.

The RBOCs' only answer is that Commission statements in the original price cap orders somehow "estop" the Commission from revisiting the initial price cap levels. *See, e.g.*, SBC Comments at 54-55. To the contrary, the Commission merely decided to adopt the price cap system without a full rate investigation; the Commission never suggested that it would refrain from taking appropriate corrective action if excessive costs were nonetheless shown (as the audits now have). *See Policy and Rules Concerning Rates for Dominant Carriers*, 4 FCC Rcd. 2873, 3245-47 (1989).

B. Accounting Corrections for Missing HWCOE.

The RBOCs have offered no evidence to rebut the reasonable conclusion that these rate impacts are likely quite substantial. The Commission should therefore continue its investigation so that it can quantify the effects on the RBOCs' rates more precisely, and it should take

³⁶*Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd. 6786, 6814 (1990). The rates set as of July 1, 1990, were then adjusted downward to reflect a rate of return equal to 11.25 percent.

corrective action. Because substantial excessive costs are almost certainly embedded in the RBOCs' price cap indices, the Commission should ultimately order a prospective downward adjustment for all price cap RBOCs that are not signatories to the CALLS Plan to remove the phantom costs of missing plant.³⁷ The Commission has ample authority to order such adjustments. *See, e.g., Bell Atlantic Tel. Cos. v. FCC*, 79 F.3d 1195, 1204 (D.C. Cir. 1996); *The Bell Atl. Tel. Operating Cos.*, Order to Show Cause, 10 FCC Rcd 5099, 5102 (1995); *The Bell Atl. Tel. Operating Cos.*, Consent Decree Order, 11 FCC Rcd 14839, 14840 (1996); *The GTE Tel. Operating Cos.*, Consent Decree Order, 9 FCC Rcd 2594, 2595 (1994); *see also* MCI WorldCom Comments at 41.³⁸

The CPR errors would also have resulted in excessive rates in prior years under the sharing rules. Here again, the RBOCs' arguments to contrary rest solely on their contentions – refuted in the Snively King Report – that the CPR errors had no impact on their revenue

³⁷*See Access Charge Reform*, CC Docket Nos. 96-262 et al., Notice of Proposed Rulemaking (rel. September 15, 1999) (seeking comment on the proposal of the Coalition for Affordable Local and Long Distance Services). For the signers of the CALLS Plan, AT&T has agreed that the price cap changes proposed in the plan are “just, reasonable and fair”—and prospective changes in interstate access rates of the signatory RBOCs based on the results of the Continuing Property Records audits shall be “unnecessary”—if the FCC adopts in their entirety the access rates proposed in the CALLS plan. CALLS Proposal, ¶ 4.2.

³⁸ Nor is there any merit to the suggestion that Section 205 of the Act would bar such a proceeding. *See, e.g., MTS and WATS Market Structure*, Third Report and Order, 93 F.C.C.2d 241, 256 n.18 (1983) (Notice and comment rulemaking sufficient to satisfy the 205(a) requirement that prescription power may be exercised only after a full opportunity for hearing); *American Tel. & Tel. Co. v. FCC*, 572 F.2d 17, 21-23 (2d Cir.), *cert. denied*, 439 U.S. 875 (1978) (same); *International Settlement Rates*, IB Docket No. 96-261, Report and Order on Reconsideration and Order Lifting Stay, FCC 99-124, para. 17 (June 11, 1999) (notice and comment provisions of section 553 of the APA satisfy a general hearing requirement such as that contained in section 205; Commission did not need to issue an order of investigation on its own motion, because NPRM satisfied the requirement and gave all interested parties ample opportunity to present their views).

requirements. *See, e.g.,* Ameritech Comments at 25; BellSouth Comments at 47-48; SBC Comments at 56. In any given year, to the extent that equipment missing at that time was never in service, the result would have been an overstatement of the rate base and/or depreciation expense, and thus an understatement of the price cap RBOCs' interstate rate of return. Under the sharing rules in effect from 1991 through 1997, if the RBOCs' interstate rates of return were understated, that would have translated directly into understated cap reductions the following year. Moreover, as AT&T showed, the impact on the price cap RBOCs' sharing amounts was almost certainly substantial, because most of the missing equipment from the more recent vintages -- *i.e.*, the period governed by the price cap regime -- was probably never placed in service at all (rather than being a delayed retirement), and therefore would have resulted in an overstated rate base. Because most of the price cap RBOCs' earnings were in the sharing zones (or qualified for a lower formula adjustment) for most of the years from 1991 to 1995 (and some price cap RBOCs, such as U S WEST, continued under sharing until 1997), these overstatements in the RBOCs' rates of return would have had a dollar-for-dollar impact on their sharing obligations.

The claims of some LECs that overstatements in the CPR would lead to an overstatement of the X-Factor under the Commission's total factor productivity ("TFP") methodology are baseless. Ameritech Comments at 25; BellSouth Comments at 49-50. To be sure, the RBOCs' overstated CPR could have caused the capital stock in the FCC's TFP study to increase over time, so that growth in inputs would have been overstated. In the absence of any other effect, the effect would have tended to understate TFP growth, which is defined as growth in output minus growth in input. But that is only half of the story. In the FCC's model, any distortion in measuring the capital stock creates an offsetting distortion in measuring the "capital rental price," which is the capital component of the overall input price index. The capital rental price is

equal to "property income" (total revenue minus operating expenses) divided by the computed capital stock. If the capital stock is overstated, the capital rental price will be understated by an offsetting amount. The understatement in TFP growth is thus accompanied by a corresponding understatement of input price growth. The understatement in TFP growth has the effect of reducing the estimated X-Factor, but the understatement of input price growth has the offsetting effect of increasing the estimated X-Factor. The two effects exactly cancel out, leaving no net effect on the X-Factor.

C. Accounting Corrections to Resolve "Undetailed Investment."

The initial comments of other parties confirm that the RBOCs should be required to show cause why the "undetailed investment" in their property accounts should be removed immediately. Except for particular items of equipment that the RBOCs can show are still used and useful, and thus for which they can generate a valid CPR, all such items should be retired forthwith and the property records should be adjusted downwards. AT&T Comments at 39-40.³⁹

³⁹ *Accord, Audit of the Continuing Property Records of the Pacific Bell and Nevada Bell Telephone Companies As of June 30, 1997* ¶ 38 (FCC Dec. 22, 1998) ("Pac-Bell Rpt.") ("the amounts associated with . . . Undetailed Investment . . . should be written off."); *Audit of the Continuing Property Records of US WEST Telephone Companies As of June 30, 1997* ¶ 38 (FCC Dec. 22, 1998) ("US WEST Rpt.") (same); *Audit of the Continuing Property Records of Ameritech Corporation As of June 30, 1997* ¶ 37 (FCC Dec. 22, 1998) ("Ameritech Rpt.") (same); *Audit of the Continuing Property Records of Southwestern Bell Telephone Company As of June 30, 1997*, ¶ 38 (FCC Dec. 22, 1998) ("SBC Rpt.") (same); *Audit of the Continuing Property Records of BellSouth Telecommunications, Inc. As of June 30, 1997*, ¶ 37 (FCC Dec. 22, 1998) ("BellSouth Rpt.") (same); BA-North Rpt. ¶ 39 (same); MCI Comments at 40 ("Commission should require the RBOCs to make downward adjustments to . . . remove the effects of plant overstatement."); New York Comments at 8 ("Federal and State regulators have an obligation to prevent such inflation and inaccuracies by performing audits as appropriate and requiring remedial action to correct for significant inaccuracies.").

D. Future Audit Requirements.

The large number of sampled items that the RBOCs and their outside auditors were unable to find during and after the audit process brings into question not only the accuracy of the RBOCs' property accounts, but also the competence and integrity of the RBOCs' accounting controls. Restoring public confidence in these critical regulatory safeguards dictates thorough scrutiny of the records by expert and disinterested parties. *See* AT&T Comments at 40. The need for comprehensive outside audits is entirely of the RBOCs' own making, through their chronic failure to maintain their property records in compliance with the Commission's long-standing requirements. *See* *See, e.g., Audit of the Continuing Property Records of BellSouth Telecommunications, Inc. As of June 30, 1997*, ¶ 32 (FCC Dec. 22, 1998) ("It is unlikely that such a large number of errors . . . occurred over a short span of years. It is much more likely that [the RBOC] has been recording a substantial percentage of its entries inaccurately for many years."); Ameritech Rpt. ¶ 33 (same); US WEST Rpt. ¶ 33 (same); SBC Rpt. ¶ 33 (same); Bell Atlantic-North Rpt. ¶ 33 (same); Pacific Bell Rpt. ¶ 33 (same).

V. OTHER ISSUES.

Many states have adopted regulatory procedures very similar to section 32.0000 of the Commission's rules. *See, e.g.,* New York Comments at 1 ("state utility regulatory agencies rely on the FCC's [USOA] to review the RBOCs' interstate plant and investments. . . . [NYPSC's] determinations of jurisdictional separations, intrastate price cap levels, and other significant findings rely on the capital investment stated in NYNEX/Bell Atlantic North's [CPR]"); Notice of Inquiry, *Comments of the Illinois Commerce Commission* at 2, CC Docket No. 99-117, ASD File No. 99-22 ("In Illinois, 83 Illinois Administrative Code Part 710 adopts the [USOA] for telecommunications carriers codified in 47 [CFR] Part 32, with minor modifications."). Failure

by the Commission to act is likely to force state regulatory agencies to institute costly separate investigations of the RBOCs. This point is illustrated by promises of Illinois and New York to look into this problem. Thus, the interest of a cost efficient and consistent resolution to the problem, further confirms the need for immediate Commission action.

CONCLUSION

For the foregoing reasons, the Commission should affirm the findings of the Staff's RBOC audit reports and order appropriate corrective actions, as described herein and in AT&T's initial comments, to remedy the RBOCs' massive overstatement of HWCOE in service.

Respectfully submitted,

/s/ Peter H. Jacoby

David M. Levy
David L. Lawson
James P. Young
Rudolph M. Kammerer
Christopher T. Shenk
SIDLEY & AUSTIN
1722 Eye Street, N.W.
Washington, D.C. 20006
(202) 736-8000

Mark C. Rosenblum
Peter H. Jacoby
Judy Sello
AT&T CORP.
Room 1135L2
295 North Maple Avenue
Basking Ridge, New Jersey 07920
(908) 221-8984

Attorneys for AT&T Corp.

October 25, 1999

CERTIFICATE OF SERVICE

I, Peter Andros, do hereby certify that on this 17th day of April, 2000, a copy of the foregoing "Petition for Reconsideration" was served via U.S. first class mail, postage prepaid, to the parties listed on the attached Service List.

/s/ Peter Andros _____
Peter Andros

SERVICE LIST

Magalie R. Salas
Federal Communications Commission
The Portals
445 12th Street, SW
Room TW-A325
Washington, DC 20554

Myra Karegianes
General Counsel
Illinois Commerce Commission
527 East Capitol Avenue
Springfield, IL 62701

Eliot Spitzer
Mary Ellen Burns
Keith H. Gordon
Attorney General of the State of New York
120 Broadway Avenue
Room 23-76
New York, NY 10271

John W. Hunter
Julie E. Rones
United States Telephone Association
1401 H. Street, NW
Suite 600
Washington, DC 20005

Edward H. Shakin
Edward D. Young III
Michael E. Glover
Bell Atlantic Corporation
1320 North Courthouse Road
8th Floor
Arlington, VA 22201

ITS Inc.
1231 20th Street, NW
Washington, DC 20036

Cynthia B. Miller
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

Lawrence E. Sarjeant
Linda L. Kent
Keith Townsend
United States Telephone Association
1401 H. Street, NW
Suite 600
Washington, DC 20005

Leander Valent
Ameritech Corporation
9525 West Bryn Mawr
Suite 600
Rosemont, IL 60018

M. Robert Sutherland
Stephen L. Earnest
BellSouth Corporation
1155 Peachtree Street, NE
Atlanta, GA 30309-3610

Andre J. Lachance
GTE Service Corporation
1850 M Street, NW
Suite 1200
Washington, DC 20036

John F. Raposa
GTE Service Corporation
600 Hidden Ridge HQE035J27
Irving, TX 75038

Gregory J. Vogt
Suzanne Yelen
Wiley, Rein & Fielding
1776 K Street, NW
Washington, DC 20006

Alfred G. Richter, Jr.
Roger K. Tompkins
Jonathan W. Royston
SBC Communications
One Bell Plaza, Room 3005
Dallas, TX 75202

James T. Hannon
Daniel L. Poole
US West, Inc.
1020 19th Street, NW
Suite 700
Washington, DC 20036

Ken Moran
Chief, Accounting Safeguards Division
Federal Communications Commission
Room 6-B201
445 12th Street, SW
Washington, DC 20554

Patricia M. Kravin
Economics and Technology, Inc.
One Washington Mall
Boston, MA 0210-2617

James S. Blaszak
Levin, Blaszak, Block &
Boothby, L.L.P.
2001 L St., N.W.
Suite 900
Washington, DC 20036

Emily C. Hewitt
George N. Barclay
Michael J. Ettner
General Services Administration
1800 F Street, N.W., Room 4002
Washington, DC 20405

Andy Mulitz
Chief, Legal Branch
Accounting Safeguards Division
Federal Communications Commission
Room 6-B201
445 12th Street, SW
Washington, DC 20554

William T. Lake
Patrick J. Carome
Julie A. Veach
Wilmer, Cutler & Pickering
2445 M Street, NW
Washington, DC 20037-1420

Snavelly King Majoros
O'Connor & Lee, Inc.
1220 L Street, NW
Suite 410
Washington, DC 20005

William Irby, Director
Division of Communications
Virginia State Corporation Commission
1300 East Main St., 9th Floor
Box 1197
Richmond, Virginia 23218

Kathryn A. Zachern
J. Wade Lindsay
Wilkinson, Barker, Knauer & Quinn L.L.P.
2300 N Street, NW
Washington, DC 20037

William F. Maher, Jr.
Halprin, Temple, Goodman & Sugrue
1100 New York Avenue, N.W.
Washington, DC 20005

Robert M. Lynch
Durward D. Dupre
Roger K. Toppins
Darryl W. Howard
Jonathan W. Royston
One Bell Plaza
Room 3022
Dallas, Texas 75202

Thomas E. Taylor
Cincinnati Bell Telephone Company
201 East Fourth Street, 6th Floor
Cincinnati, Ohio 45202

Jay C. Keithley
Sprint Corporation
1850 M Street, N.W.
11th Floor
Washington, DC 20036-5807

Sandra K. Williams
Sprint Corporation
4220 Shawnee Mission Parkway
Suite 303A
Westwood, KS 66205

M. Robert Sutherland
Stephen L. Earnest
Bell South Corporation
Suite 1700
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309-3610

Alan Buzacott
MCI Worldcom, Inc.
1801 Pennsylvania Ave., N.W.
Washington, DC 20006